REPORT OF EXAMINATION
OF THE

SUTTER INSURANCE COMPANY

AS OF
DECEMBER 31, 2003

Participating State
and Zone:

California

Filed May 19, 2005

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San Francisco, California
April 28, 2005

Honorable Alfred W. Gross
Chairman of the NAIC Financial
Condition Subcommittee
Commissioner of Insurance
Virginia Bureau of Insurance
Richmond, Virginia

Honorable John Morrison
Secretary, Zone IV - Western
Commissioner of Insurance and Securities
Montana Department of Insurance
Helena, Montana

Honorable John Garamendi
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Chairman and Commissioners:

Pursuant to your instructions, an examination was made of the

SUTTER INSURANCE COMPANY

(hereinafter also referred to as the Company) at its statutory home office and main administrative office located at 1301 Redwood Way, Suite 120, Petaluma, California 94954.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2000. This examination covers the period from January 1, 2001 through December 31, 2003. The examination was made pursuant to the National Association of Insurance Commissioners' plan of examination. The examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions within the examination period, and an evaluation of the assets and a determination of liabilities as of December 31, 2003, as deemed necessary under the circumstances.

In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of company; business in force by states; loss experience; and sales and advertising.

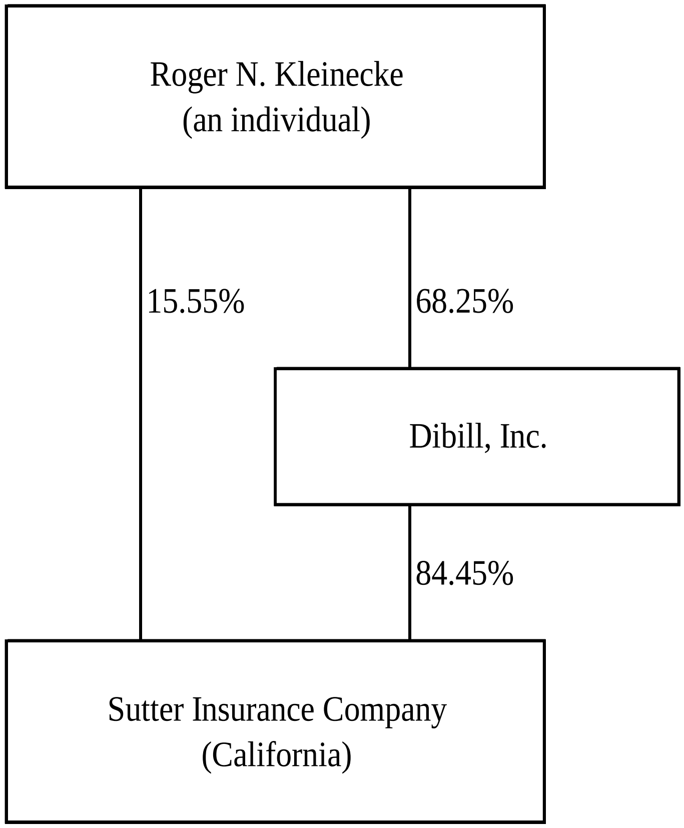
COMPANY HISTORY

In 2003, the Company increased its gross paid-in and contributed surplus from $465,000 to $2.8 million to meet minimum capital requirements in the State of California. Paid-in capital was increased by $2,335,000 through a transfer from unassigned funds.

In 2001, the Company paid a cash dividend of $300,000 to its stockholders.

MANAGEMENT AND CONTROL

The Company is part of a holding company system of which Roger N. Kleinecke is the ultimate controlling person. The Company is managed by the Kleinecke family, which includes the father Roger, daughter Diane, and son William. Roger Kleinecke directly owns 15.55% of the Company and 68.25% of Dibill, Inc. Dibill, Inc. owns the other 84.45% of the Company. The Company was the sole owner of Anza Insurance Company, which was sold on March 1, 2001. The following organizational chart depicts the relationship of the companies within the holding company system:



Management of the Company is vested in a three-member board of directors. A listing of the members of the board and principal officers serving on December 31, 2003 follows:

<u>Directors</u>

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Roger N. Kleinecke Kentfield, California	President Sutter Insurance Company
William B. Kleinecke Novato, California	Vice President Sutter Insurance Company
Diane E. Kleinecke Santa Rosa, California	Vice President, Secretary and Treasurer Sutter Insurance Company

Principal Officers

Name	Title
Roger N. Kleinecke	President
Diane E. Kleinecke	Vice President, Secretary and Treasurer
William B. Kleinecke	Vice President, Underwriting
Harry L. Boatright	Vice President, Claims

Tax Allocation Agreement

The Company is party to a tax allocation agreement with its parent company, Dibill, Inc. The agreement was reviewed by the California Department of Insurance and approved on March 25, 1999.

TERRITORY AND PLAN OF OPERATION

As of December 31, 2003, the Company was licensed to transact insurance in the states of California, Nevada, Oregon, and Washington. Approximately 94% of the Company's 2003 direct business of $53,819,955 was written in California. The Company primarily writes commercial auto liability, auto physical damage, auto warranty service contracts, private passenger auto liability and homeowners lines of business. The Company has made a significant shift in its book of business away from private passenger auto to commercial auto in late 2001, including a regional long-haul trucking program. The trucking program is written on a preferred basis. Within its commercial auto line, the Company also insures social service vehicles (vehicles used by non-profit organizations) and light trucks. Maximum limit of liability on commercial auto is $1 million combined single limit. Business is written through approximately 30 policy-issuing agents and 230 brokers. The auto warranty business is written and managed through one unaffiliated managing general agent, PRco, Inc. of Walnut Creek, California. The following schedule details the Company's 2003 direct and net premiums written by line of business:

Line of Business	Direct Premiums Written	Net Premiums Written
Commercial Auto Liability	$26,971,685	$24,226,698
Auto Physical Damage	10,338,005	10,330,020
Vehicle Service Contracts	8,528,062	8,528,062
Private Passenger Auto Liability	3,984,791	3,983,398
Homeowners and Related Lines	3,997,412	3,300,621
Totals	$53,819,955	$50,368,799

REINSURANCE

Assumed

As part of the sale of its former affiliate, Anza Insurance Company (Anza), on March 1, 2001, the Company assumed all of the insurance business in force from Anza. The sale and assumption of Anza business was approved by the California Department of Insurance. The Company also assumed minor amounts of reinsurance through mandatory pools in California.

Ceded

The Company has the following reinsurance contracts in force at December 31, 2003:

Reinsurer	Business Covered	Company Retention	Reinsurer's Maximum Limits
Motors Insurance Corporation (Authorized)	Homeowners/ Property	Effective 7/1/2003: $150,000 per loss occurrence	1st Excess - $450,000 excess of $150,000 2nd Excess - $400,000 excess of $600,000 Casualty Excess - $1 million excess of $1 million

Reinsurer	Business Covered	Company Retention	Reinsurer's Maximum Limits
Motors Insurance Corporation (Authorized)	Auto liability	Effective 10/1/2003: $250,000 per loss occurrence, subject to an $850,000 inner aggregate retention	$750,000 excess of $250,000
XL Reinsurance America, Inc. (Authorized)	Personal Articles Floater	Effective 6/1/2002: $100,000 per risk, per loss occurrence	$900,000 excess of $100,000, subject to a maximum liability of $4.5 million per occurrence
QBE Reinsurance Corporation (50%) Odyssey America Reinsurance Corporation (50%) (Both authorized)	Property Catastrophe	Effective 7/1/2003: $2 million	$4.5 million excess of $2 million, subject to a maximum liability of $9 million during the term

The Company's reinsurance agreements were not in compliance with the California Insurance Code (CIC) Section 922.2(a)(2) in regards to the offset and insolvency clauses. The Company's homeowner's reinsurance agreement contained a special termination provision which was not in compliance with CIC 922.2(a)(2). It is recommended that the Company revise these agreements to comply with California laws.

ACCOUNTS AND RECORDS

Unearned Premium

It was noted during the sampling of unearned premium that unearned premium on certain auto warranty contracts was overstated. Per the Company's data processor, Fiserv, Inc. (Fiserv), policy process date, instead of effective date was being used for the earning period. Fiserv appeared to be unaware of this, and has taken steps to correct the problem.

Another problem noted was incorrect unearned premium on policies with pro-rata cancellations. Fiserv's earning methodology on pro-rata cancellations produces a negative unearned premium when the original expiration of the policy exceeds the accounting date. The net result of both types of errors was immaterial.

The Company should take steps to ensure that its data processor, Fiserv, uses the correct contract inception dates when calculating the unearned premium on auto warranty contracts. The Company should also take appropriate measures to address the understatement of unearned premium resulting from Fiserv's earning methodology on pro-rata cancellations.

Information Systems Controls

A review was made of the Company's general information systems controls. Several control weaknesses were noted as follow:

1. Physical security of the computer room: It is recommended that the Company implement procedures to ensure that the computer room and the file cabinet containing check stock is locked when left unattended.
2. Control testing of data processing provider: The Company outsources data processing of financially significant applications to Fiserv. Fiserv provides a Type I Service Auditor's Report (SAS 70), which describes the general controls in place, to the Company on an annual basis. It is recommended that the Company obtain an annual Type II SAS 70, which tests the operating effectiveness of those controls, in order for controls at Fiserv to be relied upon.
3. Disaster Recovery Plan: The Company's Disaster Recovery Plan should be updated on a regular basis, tested, and copies provided to officers and key managers.
4. Limitation of liability clause in Data Processing Agreement: The Data Processing Agreement with FiServ contains a limitation of liability clause that limits FiServ's liability to the fees paid by the Company in the event of any loss, damage or injury, regardless of the nature, including, but not limited to, contract, negligence, warranty, or strict liability in tort. The Company's interests are not legally protected in the event that FiServ is negligent, resulting in loss of data, inaccurate data and reporting, or business interruption. This becomes especially important due

to the absence of control testing by an independent party. It is recommended that the Company consult with legal counsel regarding this clause in order to protect its interests.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2003

Underwriting and Investment Exhibit for the Year Ended December 31, 2003

Reconciliation of Surplus as Regards Policyholders from December 31, 2000 through December 31, 2003

Statement of Financial Condition
as of December 31, 2003

Assets	Ledger and Nonledger Assets	Nonadmitted Assets	Net Admitted Assets	Notes
Bonds	$58,385,330	$	$58,385,330	
Common stocks	298,680		298,680	
Cash and short-term investments	3,110,985		3,110,985	
Investment income due and accrued	796,973		796,973	
Premiums and considerations:				
Uncollected premiums and agents' balances in the course of collection	3,588,036	218,438	3,369,598	
Deferred premiums, agents' balances and installments booked but deferred and not yet due	637,958		637,958	
Amounts recoverable from reinsurers	49,551		49,551	
Current federal and foreign income tax recoverable	622,245		622,245	
Net deferred tax asset	2,333,301		2,333,301	(1)
Aggregate write-ins for other than invested assets	33,663		33,663	
Total assets	$69,856,722	$ 218,438	$69,638,284	

Liabilities, Surplus and Other Funds

Losses		$16,897,154	(2)
Loss adjustment expenses		3,362,664	(2)
Commissions payable, contingent commissions and other similar charges		316,044	
Other expenses (excluding taxes, licenses and fees)		439,645	
Taxes, licenses and fees (excluding federal and foreign income taxes)		355,615	(3)
Net deferred tax liability		91,734	(1)
Unearned premiums		24,667,339	
Ceded reinsurance premiums payable		2,000,644	
Drafts outstanding		30,876	
Aggregate write-ins for liabilities		30,758	
Total liabilities		48,192,473	
Common capital stock	$ 3,000,000		
Gross paid-in and contributed surplus	2,800,000		
Unassigned funds (surplus)	15,645,811		
Surplus as regards policyholders		$21,445,811	
Total liabilities, surplus and other funds		$69,638,284	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2003

Statement of Income

Underwriting Income		
Premiums earned		$43,929,753
Deductions:		
Losses incurred	$24,889,041	
Loss expenses incurred	5,130,453	
Other underwriting expenses incurred	14,618,137	
Total underwriting deductions		44,637,631
Net underwriting loss		(707,878)
Investment Income		
Net investment income earned	$ 2,297,433	
Net realized capital gains	30,989	
Net investment gain		2,328,422
Net income before federal income taxes		1,620,544
Federal income taxes incurred		1,255,152
Net income		$ 365,392

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2002		$20,219,317
Net income	$ 365,392	
Change in net unrealized capital gains	57,600	
Change in net deferred income tax	687,974	
Change in nonadmitted assets	115,528	
Change in surplus as regards policyholders		1,226,494
Surplus as regards policyholders, December 31, 2003		$21,445,811

Reconciliation of Surplus as Regards Policyholders
from December 31, 2000 through December 31, 2003

	Gain in Surplus	Loss in Surplus	
Surplus as regards policyholders, December 31, 2000, per Examination			$19,800,197
Net income	$ 997,486	$	
Change in net unrealized capital losses		1,335,449	
Change in net deferred income tax	1,909,596		
Change in nonadmitted assets	42,013		
Cumulative effect of changes in accounting principles	331,968		
Capital change: Transferred from surplus	2,335,000		
Capital change: Transferred to capital		2,335,000	
Dividends to stockholders (cash)		300,000	
Total gains and losses	$ 5,616,063	$ 3,970,449	
Increase in surplus as regards policyholders			1,645,614
Surplus as regards policyholders, December 31, 2003, per Examination			$21,445,811

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Net Deferred Tax Asset and Net Deferred Tax Liability

The Company reported its gross Deferred Tax Asset and gross Deferred Tax Liability separately as both an asset and a liability, instead of showing them net. For examination purposes, no reclassification was made as the amounts involved were not material and the Company correctly reported these two accounts in its 2004 Annual Statement.

(2) Losses and Loss Adjustment Expenses

The California Department of Insurance (CDI) retained an independent consulting actuary to perform an analysis of the Company's loss and loss adjustment expenses reserves. A Casualty Actuary with the CDI reviewed the analysis and concurred with the conclusion that the reserves were determined to be reasonable.

(3) Taxes, Licenses and Fees

California Insurance Code (CIC) Section 1872.8(a) states, in part, that each insurer doing business in the State of California must pay an annual Vehicle Fraud Assessment Fee for each vehicle insured under an insurance policy it issues in California. The fee provides funding for the increased investigation and prosecution of fraudulent automobile insurance claims and automobile theft in the State of California.

A review was made of the Company's Fraud Assessment Filings for 2003, and the methodology used for obtaining vehicle counts. The Company uses a methodology that estimates policies in force and average vehicles insured per policy type as the Company's information system does not capture the data needed to enable an actual count of the insured vehicles in accordance to California Department of Insurance (CDI) filing instructions. Our testing of the Company's methodology indicated additional insured vehicles of approximately 18,000 during 2003. The difference was due mainly to: small segments of Company's business inadvertently not being reported (e.g., trailers), and the application of a higher average vehicle per policy factor than that used by the Company for the commercial auto line. Given that the Company employed the same methodology in prior years, it is believed that the underreporting of insured vehicles extends to other filing years. It is recommended that the Company employ methods to calculate the number of vehicles insured based on actual quarterly in-force counts using the procedures required by regulations. It is also recommended that the Company work with the CDI to address the underreporting issue for all reporting years.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Reinsurance – Ceded (Page 5): The Company's reinsurance agreements were not in compliance with the California Insurance Code (CIC) Section 922.2(a)(2) in regards to the offset and insolvency clauses. The Company's homeowner's reinsurance agreement contained a special termination provision which was not in compliance with CIC 922.2(a)(2). It is recommended that the Company revise these agreements to comply with California laws.

Accounts and Records - Unearned Premium (Page 6): A methodology error was noted in the calculation of unearned premium on policies with pro-rata cancellations, whereby a negative unearned premium was produced on policies in which the original expiration date exceeded the accounting date. The Company should take appropriate measures to address the understatement of unearned premium due to this methodology error.

Accounts and Records – Information Systems Controls (Page 7): It is recommended that the Company continue to work towards improving the weaknesses noted in its information systems controls. In addition, the Company should amend its data processing agreement with Fiserv, Inc. to require a Type II SAS 70 review on an annual basis. The Company should consider amending the Limitation of Liability Clause in the data processing agreement.

Comments on Financial Statement Items – Taxes, Licenses and Fees (Page 12): A review was made of the Company's methodology for reporting insured vehicles for the California Fraud Assessment Fee. Our testing of the Company's methodology indicated additional insured vehicles of approximately 18,000 in 2003. It is recommended that the Company employ methods to calculate the number of vehicles insured based on actual quarterly in-force counts using the procedures required by regulations. It is also recommended the Company work with the California Department of Insurance to address the underreporting issue for all reporting years.

Previous Report of Examination

Account and Records: Information Systems Review – (Page 8): It was recommended that the Company obtain a Service Auditor's Report (SAS 70) from its processing systems contractor, Fiserv, Inc. (Fiserv). The Company complied by amending its data processing agreement with Fiserv to require annual Type I SAS 70's of Fiserv. This examination is further recommending that a Type II SAS 70 be obtained.

Bonds, Stocks and Short-term Investments (Page 12): It was recommended the Company submit its custodial agreement with Union Bank of California to the California Department of Insurance for approval. The Company's custodial agreement was changed to a form approved by the California Department of Insurance, and therefore complies.

ACKNOWLEDGEMENT

The courtesy and cooperation extended by the Company's officers and employees during the course of this examination are hereby acknowledged.

Respectfully submitted,

/S/

Isabel Spiker, CFE
Examiner-In-Charge
Senior Insurance Examiner
Department of Insurance
State of California